Date Introduced: 22 February 1985
House: House of Representatives
Presented by: Hon. P.J. Keating, M.P., Treasurer

Purpose

1. To recover income tax avoided through the use of new generation trust stripping schemes. The Act will come into operation on the date of Royal Assent.

Background

2. Legislation against trust stripping schemes was enacted in 1979 and amendments to strengthen the legislation were made in 1981. Despite that legislation and the enactment of new general anti-tax avoidance legislation, trust stripping schemes continue to be devised. Under new generation trust stripping schemes income of a family trust is formally allocated, directly or through a chain of trusts, to a beneficiary - such as a tax exempt charity - that is not required to pay tax on the income. However, although the charity is given a vested and indefeasible interest in the income - this has an important effect for income tax purposes which is explained at paragraph 5 below - it does not become entitled to the payment of the income or the bulk of the income until some years hence, generally, 80 years hence.

3. In the meantime the charity may be paid a token payment with the balance - undiminished by the payment of tax - being used for the benefit of family members, for example, interest free loans for up to 80 years.

4. Even if the income that is formally allocated to the charity is ultimately paid to the charity in 80 years time, the present value of the amount is negligible. For example, $100,000 when discounted at an interest rate of 10% per annum for 80 years is equivalent to less than $50 payable today. Thus, by conferring a benefit worth, in effect, less than $50 on a charity, a family can avoid up to $60,000 in tax.

5. The significance of giving a charity a vested and indefeasible interest in the income is that that has the
effect of deeming the charity, by virtue of section 95A(2) of the Income Tax Assessment Act (ITAA), to be presently entitled to the income for tax purposes, thus freeing the trustee from tax on the income. Income of a trust to which no beneficiary is presently entitled is taxable to the trustee under section 99A of the ITAA at the rate of 60%. If, on the other hand, the income had been distributed to the family members it would have been taxable to the family member concerned (or to the trustee in certain cases, e.g., where the family member is a minor) along with his/her other income.

Outline

6. The Bill proposes that the tax avoided through a new generation trust stripping arrangement entered into on or after 1 July 1980[1] be recouped either from the trustee of the trust (the head trust where a chain of trusts are involved) or alternatively - generally at their option - from the beneficiaries.

7. As indicated in the previous paragraph there are exceptions to the general rule that a beneficiary will only be liable for tax at his, her or its option. In cases where a stripped trust has ceased to exist, its beneficial ownership has changed, or it is unlikely to pay the trust recoupment tax on the income and the beneficiaries have not elected to be assessed on the stripped income, the Bill proposes that those who benefitted from the stripped income be jointly and severally liable for trust recoupment tax on the stripped income. Taxpayers who are made jointly and severally liable for the tax in these circumstances are given rights, by the Bill, to have the appropriate adjustments made to their liability by a court, or to recover the appropriate part of such tax paid by them from other beneficiaries through the courts.

8. The Bill also proposes that penalty tax be payable on the tax avoided where the schemes were entered into after 28 April 1983, the day on which the Government announced its policy on retrospective anti-tax avoidance legislation.

Main Provisions

(a) Application of the Income Tax Assessment Act (ITAA)

9. Clause 4 of the Bill will operate to adapt and apply for purposes of the trust recoupment tax the machinery provisions of the income tax law.
(b) Liability at Primary Level/Identification of Schemes

10. Clause 5 of the Bill is a key provision. Broadly, it looks to the existence of a tax avoidance arrangement entered into on or after 1 July 1980 under which a beneficiary is given an indefeasible vested interest in, but no present entitlement to, income of a trust estate and the present value of the ultimate benefit that the beneficiary will receive is less than 50 per cent of the income that is formally allocated to the beneficiary. An interest rate of 10% per annum is by sub-clause 5(5) to be used for purposes of establishing the present value of an amount. In such circumstances the trustee (or, if the income of the trust has been distributed to the trust by another trust, the trustee of the head trust) will be liable, in the first instance, for trust recoupment tax on the stripped income.

11. The mechanism which clause 5 employs to create the tax liability is by establishing that the trustee of the trust, in which the tax exempt body has an indefeasible vested interest, has a "primary taxable amount". This amount will, by sub-clause 5(1), be equal to that part of the income of the trust on which the trustee would have been liable for income tax, under section 99A of the ITAA, if the beneficiary who was given an indefeasible vested interest in the income of the trust had not been deemed to be presently entitled to the income.

12. Where the trustee a trust that has a "primary taxable amount" derived the income from another trust, the "primary taxable amount" is, by sub-clause 5(2), to be transferred successively through the chain of trusts to the head trust.

13. Sub-clause 8(1) of the Bill makes a trustee who has a "primary taxable amount" liable for trust recoupment tax on that amount. This tax is to be imposed, at the rate of 60% by the Trust Recoupment Tax Bill 1985. The 60% rate is equivalent to that payable by a trustee, under section 99A of the ITAA, on income of a trust to which no beneficiary is presently entitled.

(c) Liability at Secondary Level

14. There will be three situations where the tax established in accordance with the arrangements described above may not be recouped, or where it may not be appropriate to recoup the tax from the present trustee. These situations, together with the sub-clause of the Bill which deals with each particular situation, are, very broadly:
(a) that the stripped trust no longer exists - sub-clause 6(1);

(b) that the stripped trust now has different beneficiaries as a consequence of sales of beneficial interests in the trust - sub-clause 6(2); and

(c) that the stripped trust is unlikely to pay the trust recoupment tax for which it is liable and the beneficiaries in the trust have not elected (see election arrangements paragraphs 20 to 27 below) to be assessed on the stripped income - sub-clause 6(3).

15. Where these circumstances exist, the relevant sub-clause provides for the eligible beneficiaries (see notes on this term at paragraphs 17 to 19 below) to pay the tax on the stripped income. The mechanism by which this is done is to determine that a "secondary taxable amount" is applicable to the eligible beneficiaries. For those eligible beneficiaries to which sub-clause 6(1) or 6(2) applies the "secondary taxable amount" will be the same amount as the "primary taxable amount" applicable to the trustee of the stripped trust (i.e., the amount of the stripped trust income) while for those to which sub-clause 6(3) applies it will be the amount that when taxed at 60% (the rate of trust recoupment tax payable on the "primary taxable amount") will result in tax equal to the unpaid trust recoupment tax.

16. Sub-clause 8(2) of the Bill makes those persons etc. who fall into an eligible beneficiary class to which a "secondary taxable amount" applies jointly and severally liable to pay the tax that is imposed on that amount (at a rate of 60%) by the Trust Recoupment Tax Bill 1985. The beneficiaries of a stripped trust that has ceased to exist or in which the beneficial interests have been sold will, however, have an opportunity to eliminate their liability for trust recoupment tax by making an election under clause 7 to be assessed to income tax on amounts equal in aggregate to the stripped income (see paragraphs 20 to 27 below re election arrangements). Those beneficiaries referred to in paragraph 14(c) above will have already had a right of election in respect of the trustee's liability at the primary level.

17. The persons who will fall into the eligible beneficiaries class are described in sub-clauses 6(4) to (6) of the Bill. Broadly, these persons are those beneficiaries of the stripped trust and other participants in the scheme (or their associates) who have, directly or indirectly,
derived a benefit that is attributable to the stripped trust income.

18. Among the beneficiaries who would be treated as eligible beneficiaries under this test would be:
   
   . a beneficiary (or associate) who received a loan out of the stripped income interest free for say 80 years;
   
   . a beneficiary who made a capital gain from the stripping of the income by disposing of his or her beneficial interest in the trust;
   
   . a trustee of a sub-trust who received a distribution out of the stripped income and who effectively retained the amount for the trust's (or its beneficiaries') benefit; and
   
   . a person who received a loan out of the stripped income that is not intended to be repaid.

19. Certain persons will, however, be expressly excluded from the eligible beneficiaries class. Excluded from the class will be a third party who derived a benefit as a result of a bona fide arm's length transaction. A charity that is a nominal beneficiary under the scheme will also be excluded from the class.

(d) Election Arrangements

20. Clause 7 of the Bill proposes, at the option of the bona fide beneficiaries in a trust (other than persons in the capacity of trustee of a trust) an alternative means to that proposed by clauses 5 and 6 for the recovery of the avoided tax.

21. The alternative arrangements provide for the trust recoupment tax liability of a trustee to be cancelled (paragraph 7(7)(c)) and/or any "secondary taxable amount" derived from a "primary taxable amount" to be taken as not existing (paragraph 7(7)(d)) where:

   (a) those beneficiaries who could reasonably be expected to have benefited from a distribution of the stripped income had it been made at the relevant distribution time - normally the time immediately before the tax avoidance scheme was entered into - unanimously elect to be assessed to income tax on shares of the trust
income equal in total to the primary taxable amount of the trustee; and

(b) the Commissioner of Taxation is satisfied that the allocation of the trust income between the electors is reasonable and that the persons concerned will where appropriate pay tax on the amounts to be included in their income tax assessable income, or, in the case of a company beneficiary, on an amount that is to be treated as a taxable amount - see paragraphs 23 to 27 below re the rules that apply where a company is a beneficiary.

22. Where a party to an election, that has been accepted by the Commissioner, is what is termed in the legislation a prescribed person - broadly, individuals, tax exempt bodies, superannuation funds and certain non-profit or government controlled public companies - that person, etc., will be treated as though he, she or it had been entitled to a share of the income of the stripped trust of the year of income in which the stripping arrangement occurred. The trust income so allocated will be treated as either assessable income (e.g., where the beneficiary is an individual) or exempt income (e.g., where the beneficiary is a tax exempt body) as the case requires.

23. Where a party to an election that is accepted by the Commissioner is a company (other than a company of the type mentioned in paragraph 22) the company will initially be liable to pay trust recoupment tax on its share of the stripped income (which share for these purposes is called an "elected taxable amount"), at the rate of 75% - sub-paragraph 7(7)(a)(ii) when read with clause 5 of the Trust Recoupment Tax Bill is to that effect. This percentage represents the combined effect of the company tax (at the rate of 46%) that would have been payable by the company on its share of the stripped income, and the personal tax that would have been payable by shareholders in the company at the maximum marginal rate of tax, i.e., 60%, if the company had distributed a sufficient amount of the income (48.6% of the income) to avoid undistributed profits tax. However, further election arrangements, as outlined in paragraph 24, are to be available in such cases.

24. As indicated above a further right of election will be available to those prescribed persons (see definition of that term at paragraph 22 above) who could reasonably be expected to have received a dividend payment from the company if one had been made out of the stripped trust income, generally, at the time immediately before the tax avoidance scheme was entered into. Sub-clause 7(2) is to
that effect. Under this option the prescribed persons may
elect to pay income tax on the amounts that would have been
payable to them as dividends (i.e., in effect on deemed
dividends) equal to 48.6% of the stripped income.

25. If an election made under the arrangements set out
in the previous paragraph is accepted by the Commissioner,
(i.e., he is satisfied as to the bona fides of the persons
making the election) sub-clause 7(8) will operate to make
the electors liable for income tax on the deemed dividends
and to convert the company's "elected taxable amount" to a
"company taxable amount". This conversion will have the
effect, insofar as the company is concerned, of reducing the
rate of tax payable by the company on its share of the
stripped income from 75% to the company tax rate of 46%.

26. In certain cases it may not be practicable for a
company which would have shared in a distribution of the
stripped trust income, but for the stripping scheme, to be a
party to an election (e.g., the company may no longer
exist). To meet these situations, sub-clause 7(3) provides
for the prescribed persons who would have benefited,
directly or through interposed companies and trusts, from a
dividend payment by the company if one had been made at the
time the tax avoidance scheme was entered into, to elect to
be assessed on the company's share of the stripped income in
lieu of the company.

27. Where prescribed persons are substituted for a
company under the arrangements outlined in paragraph 26 they
will be required, by sub-clause 7(7), to pay trust
recoupment tax equal in aggregate to the company tax that
would have been payable by the company on its share of the
stripped trust income as well as being assessed to pay
personal income tax on the deemed dividends.

(e) Avoidance of Double Taxation

28. Clause 9 of the Bill will ensure that trust
recoupment tax is only collected once in a case where there
is a liability for trust recoupment tax at both the primary
and secondary levels. That situation arises where the
trustee of a stripped trust is unlikely to pay its trust
recoupment tax liability and its liability is traced, by
virtue of sub-clause 6(3), to the eligible beneficiaries
class.

29. By clause 9, a payment at one level will reduce the
amount of trust recoupment tax payable at the other level.
(f) Rights of Contribution and Apportionment of Liability

30. As the liability of an eligible beneficiaries class for trust recoupment tax is a joint and several one on the members of the class, it could occur that one or more of the members of the class is called upon to pay the trust recoupment tax that is the responsibility also of other members of the class.

31. Clause 10 gives a person in the eligible beneficiaries class, who is called upon by the Commissioner of Taxation to pay trust recoupment tax, two avenues for taking action which will result in other members of the class being required to contribute an appropriate share of the tax.

32. The first avenue is for the person to pay the tax and then recover, by action in the courts, an appropriate contribution from other members of the class. This right is to be exercised in a court of competent jurisdiction, which may order such sharing of the tax as appears just and equitable.

33. Alternatively, the person may, when sued by the Commissioner for the unpaid trust recoupment tax, act to have other members of the class joined as co-defendants to the recovery suit. Where this avenue is taken the court will, having regard to levels of benefits enjoyed or to be enjoyed, have power to determine how much of the unpaid amount it is just and equitable that the person sued, and each of the persons joined, should be liable to pay as trust recoupment tax.

(g) Penalty Tax

34. By clause 12 of the Bill additional (penalty) tax is to be imposed on a trustee or other person liable for tax under the Bill where the scheme was entered into after 28 April 1983 - that being the date on which the then Minister for Finance spelt out in a ministerial statement the Government's policy on retrospective anti-tax avoidance legislation.

35. Where a scheme was entered into after 28 April 1983 and prior to the commencement of this legislation, the penalty tax will, broadly, be equal to that amount which, based on movements in the Consumer Price Index, will make the tax to be recovered under this legislation equal to the tax that would have been paid at the time the scheme was entered into plus the adjustment necessary to bring that amount to present day terms. Where a scheme is entered into after the commencement of this legislation, the penalty tax
will be double the basic tax arising under this legislation. In both situations, the statutory penalty tax will be subject to the general power of remission vested in the Commissioner.

(h) Safeguard Against Divestment of Assets

36. Clause 13 contains provisions - foreshadowed on 28 April 1983 - to render void arrangements entered into after that date which have the dominant purpose and the effect of directly or indirectly defeating, evading or avoiding a person's liability to pay tax arising under this legislation. Where a scheme involves a transfer of, or diminution in the value of, any property of a person liable to pay such tax, that scheme will be void in any proceedings commenced by the Commissioner or by a liquidator or trustee in bankruptcy which are designed to recover such tax. A scheme of this nature entered into for the purpose of rendering a person unable to meet a potential liability to tax arising under the legislation will also be void if, at a later time, that person is assessed to pay such tax and fails to pay that tax.

37. More detailed explanations of the clauses of the Bill are contained in the Explanatory Memorandum.

For further information, if required, contact:

Economics and Commerce Group
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28 June 1985

Reference

1. Amendments made to the Bill changed this date to 12 May 1982, the date following that on which the previous Treasurer announced that should the then existing legislation be found to be inadequate to strike down any scheme of the trust stripping type, remedial legislation would be made retrospective to 12 May 1982.